



KPMG LLP
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INDEPENDENT AUDITORS' REPORT

The Inspector General, United States Department of Energy and
The Secretary, United States Department of Energy:

We were engaged to audit the accompanying consolidated balance sheet of the United States Department of Energy (Department) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, financing, and custodial activities, and the related combined statement of budgetary resources (hereinafter referred to as "fiscal year 2005 consolidated financial statements"), for the year then ended. In connection with our fiscal year 2005 engagement, we were also engaged to consider the Department's internal control over financial reporting and to test the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on its consolidated financial statements.

We have audited the accompanying consolidated balance sheet of the United States Department of Energy as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, financing, and custodial activities, and the related combined statement of budgetary resources (hereinafter referred to as "fiscal year 2004 consolidated financial statements"), for the year then ended. As discussed in this report, the Department's power administrations, whose Department-related financial data as of and for the year ended September 30, 2004 are included in the accompanying fiscal year 2004 consolidated financial statements, were audited by other auditors whose reports have been furnished to us and were considered in forming our overall opinion on the Department's fiscal year 2004 consolidated financial statements.

Summary

As stated in our report on the consolidated financial statements, the scope of our work was not sufficient to enable us to express an opinion on the Department's consolidated financial statements as of and for the year ended September 30, 2005. Regarding the fiscal year 2004 consolidated financial statements, we concluded, based upon our audit and the reports of other auditors, that the Department's consolidated financial statements as of and for the year ended September 30, 2004, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our report emphasizes that the cost estimates supporting the Department's environmental remediation liabilities are based upon assumptions regarding future actions and decisions, many of which are beyond the Department's control.

Our fiscal year 2005 consideration of internal control over financial reporting resulted in the identification of the following two matters as reportable conditions: (1) weaknesses in financial



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management and reporting controls related to the fiscal year 2005 implementation of the Department's new accounting system, combined with the restructuring and consolidation of its finance and accounting services organization and adoption of a new chart of accounts; and (2) weaknesses in the Department's unclassified network and information systems security. We consider the first matter to be a material weakness.

The results of our fiscal year 2005 tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The results of our tests of FFMIA disclosed that the Department's financial management systems did not substantially comply with the federal financial management systems and accounting standards requirements, as a result of the Department's inability to prepare timely and accurate financial statements and supporting data for audit. This matter is related to the material weakness in internal controls, described above.

Had we been able to perform all of the procedures necessary to express an opinion on the Department's fiscal year 2005 consolidated financial statements, other internal control matters and other instances of noncompliance may have been identified and reported.

The following sections discuss:

- The reasons why we are unable to express an opinion on the Department's fiscal year 2005 consolidated financial statements;
- Our report on the Department's fiscal year 2004 consolidated financial statements;
- Our consideration of the Department's internal control over financial reporting;
- Our tests of the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements;
- Management's responsibilities; and
- Our responsibilities.

Report on the Consolidated Financial Statements

We were engaged to audit the accompanying consolidated balance sheet of the United States Department of Energy as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, financing, and custodial activities, and the related combined statement of budgetary resources, for the year then ended.

The Department implemented a new financial accounting system in April 2005, shortly after the October 2004 reorganization and consolidation of its finance and accounting services organization. The Department also adopted a new chart of accounts in conjunction with the new accounting system. As a result of these events, the Department encountered a significant number



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of conversion, posting, reconciliation, and reporting issues that hindered its ability to assure the accuracy and completeness of consolidated financial statement balances and to provide data necessary for audit testing. We noted specific issues in accounting for obligations, monitoring budget execution and control, reconciling payment information with the U.S. Treasury, accounting for accruals, reconciling integrated contractor trial balances with the Department's records, reconciling accounting system modules to the general ledger, resolving various posting errors, and identifying and reporting intragovernmental transactions. We noted that many reports needed for management, internal control, and audit purposes were not available following system deployment. Finally, during fiscal year 2005, the Department restructured and consolidated its accounting operations, realigning its accounting functions across the Department and causing a negative impact on the financial accounting staffing levels and skills mix throughout the Department. The Department did not complete corrective actions to address these conditions. Therefore, it was unable to provide accurate financial data and could not always provide supporting documents required for audit. It was impracticable to extend our procedures sufficiently to determine the extent to which the Department's consolidated financial statements as of and for the year ended September 30, 2005, may have been affected by these conditions.

Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying consolidated financial statements of the United States Department of Energy as of and for the year ended September 30, 2005.

We have audited the accompanying consolidated balance sheet of the United States Department of Energy as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, financing, and custodial activities, and the related combined statement of budgetary resources, for the year then ended.

We did not audit the fiscal year 2004 financial statements of Bonneville Power Administration, Western Area Power Administration, Southwestern Power Administration, or Southeastern Power Administration, whose Department-related financial data as of and for the year ended September 30, 2004 are included in the accompanying fiscal year 2004 consolidated financial statements. When combined and compared to the Department's consolidated financial statements, the financial data for these entities represent 17 percent of total assets; 54 percent of total earned revenues; and 13 percent of total program costs as of and for the year ended September 30, 2004. Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinion on the fiscal year 2004 consolidated financial statements, insofar as it relates to the amounts included for Bonneville Power Administration, Western Area Power Administration, Southwestern Power Administration, and Southeastern Power Administration, is based solely upon the reports of the other auditors.

In our opinion, based upon our fiscal year 2004 audit and the reports of other auditors, the fiscal year 2004 consolidated financial statements referred to above present fairly, in all material respects, the financial position of the United States Department of Energy as of September 30, 2004, and its net costs, changes in net position, budgetary resources, reconciliation of net costs to



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budgetary obligations, and custodial activities for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Notes 14 and 16 to the consolidated financial statements, the cost estimates supporting the Department's environmental remediation liabilities of \$190 billion (unaudited) and \$182 billion as of September 30, 2005 and 2004, are based upon assumptions regarding future actions and decisions, many of which are beyond the Department's control.

The information in the Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), and Required Supplementary Information (RSI) sections of the Department's *Fiscal Year 2005 Performance and Accountability Report* is not a required part of the consolidated financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Circular A-136, *Financial Reporting Requirements, Part A, Form and Content of the Performance and Accountability Report*. We have applied certain limited procedures which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. Certain information presented in the MD&A, RSSI, and RSI is based on data from the fiscal year 2005 consolidated financial statements on which we express no opinion. The Department did not include a schedule of intragovernmental amounts by trading partner in the RSI section of its *Fiscal Year 2005 Performance and Accountability Report*, as required by OMB Circular A-136. We were not required to audit the MD&A, RSSI, and RSI information and, accordingly, we express no opinion on that information.

We were engaged to conduct our fiscal year 2005 audit, and we conducted our fiscal year 2004 audit, for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The information in the Consolidating Schedules section of the Department's *Fiscal Year 2005 Performance and Accountability Report* is presented for purposes of additional analysis of the consolidated financial statements, rather than to present the financial position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activities of the Department's components individually. The fiscal year 2005 information in the Consolidating Schedules section is based on the fiscal year 2005 consolidated financial statements on which we express no opinion, and accordingly, we express no opinion on such information. The fiscal year 2004 information in the Consolidating Schedules section has been subjected to the auditing procedures applied in the audit of the fiscal year 2004 consolidated financial statements and, in our opinion, based upon our audit and the reports of other auditors, is fairly stated in all material respects in relation to the fiscal year 2004 consolidated financial statements taken as a whole.

The information in the Performance Results section, the Other Accompanying Information section, the Appendices, and the information presented on pages i and ii of the Department's *Fiscal Year 2005 Performance and Accountability Report* is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. This information has not been subjected to the auditing procedures, except for the testing of controls over selected performance measures, described in the Responsibilities section of this report, and, accordingly, we express no opinion on it.



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Internal Control over Financial Reporting

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2005 engagement, we noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. The following reportable condition, described in more detail in Exhibit I, is considered to be a material weakness.

Financial Management and Reporting Controls – Our work identified significant deficiencies in the Department's financial management and reporting controls that precluded the Department from preparing its fiscal year 2005 consolidated financial statements and supporting documentation in a complete and timely manner. Due primarily to issues resulting from the implementation of its new accounting system and attrition associated with the reorganization and consolidation of its finance and accounting services organization, the Department was unable to develop adequate reporting and other internal controls essential to the deployment of the new system. In addition to impairing the Department's financial reporting, the lack of these critical controls detracted from the ability of the accounting staff to complete routine accounting reconciliations and impacted the ability of the Department's officials to manage their programs and monitor the status of obligations. Continued action to address these weaknesses is needed to correct the Department's financial management and reporting problems and to improve the ability of program officials to monitor and control obligations and expenditures.

The following reportable condition, which is not considered to be a material weakness, is described in more detail in Exhibit II.

Unclassified Network and Information Systems Security – We noted network vulnerabilities and weaknesses in access and other security controls in the Department's unclassified computer information systems. The identified weaknesses and vulnerabilities increased the risk that malicious destruction or alteration of data or unauthorized processing could occur. The Department should fully implement policies and procedures to improve its network and information systems security.



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The current status of the prior year reportable condition is presented in Exhibit III.

We will report on other matters involving internal control over financial management systems and its operation, and internal control over financial reporting and its operation, in separate letters.

As discussed in our report on the consolidated financial statements, the scope of our work was not sufficient to enable us to express an opinion on the Department's consolidated financial statements as of and for the year ended September 30, 2005. Had we been able to perform all of the procedures necessary to express an opinion, other matters involving internal control over financial reporting may have been identified and reported.

Compliance and Other Matters

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements described in the Responsibilities section of this report, exclusive of those referred to in the FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin No. 01-02.

The results of our tests of FFMIA disclosed that the Department's financial management systems did not substantially comply with the federal financial management systems and accounting standards requirements, discussed in the Responsibilities section of this report, which prevented the Department from preparing timely and accurate financial statements and supporting data for audit. This matter is related to the material weakness in internal controls, described in the Internal Control over Financial Reporting section of this report, and our related recommendations and are presented in Exhibit I. The results of our tests of FFMIA disclosed no instances in which the Department's financial management systems did not substantially comply with requirements of applying the United States Government Standard General Ledger at the transaction level.

As discussed in our report on the consolidated financial statements, the scope of our work was not sufficient to enable us to express an opinion on the Department's consolidated financial statements as of and for the year ended September 30, 2005. Had we been able to perform all of the procedures necessary to express an opinion, other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported.

Responsibilities

Management's Responsibilities. The *Government Management Reform Act of 1994* (GMRA), *Accountability of Tax Dollars Act*, and *Government Corporation Control Act* require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these reporting requirements, the Department prepares and submits consolidated financial statements in accordance with Part A of OMB Circular A-136.



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Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America;
- Preparing MD&A (including the performance measures), RSSI, and RSI;
- Establishing and maintaining internal controls over financial reporting; and
- Complying with laws, regulations, contracts, and grant agreements, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

Auditors' Responsibilities. As discussed in our report on the consolidated financial statements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying consolidated financial statements of the Department as of and for the year ended September 30, 2005.

Regarding the fiscal year 2004 consolidated financial statements presented herein, our responsibility is to express an opinion on the fiscal year 2004 consolidated financial statements of the Department based upon our audit and the reports of other auditors. We conducted our fiscal year 2004 audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate under the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall consolidated financial statement presentation.

We believe that our fiscal year 2004 audit and the reports of other auditors provide a reasonable basis for our opinion on the Department's fiscal year 2004 consolidated financial statements.

In connection with our fiscal year 2005 engagement, we considered the Department's internal control over financial reporting by obtaining an understanding of the Department's internal



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control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls to determine our procedures. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. Further, had we been able to perform all of the procedures necessary to express an opinion on the Department's fiscal year 2005 consolidated financial statements, other matters involving internal control over financial reporting may have been identified and reported. The objective of our engagement was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, in fiscal year 2005, we considered the Department's internal control over the RSSI by obtaining an understanding of the Department's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Had we been able to perform all of the procedures necessary to express an opinion on the Department's fiscal year 2005 consolidated financial statements, other matters involving internal control over the RSSI may have been identified and reported. Our procedures were not designed to provide assurance on internal control over the RSSI and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in MD&A, in fiscal year 2005, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Had we been able to perform all of the procedures necessary to express an opinion on the Department's fiscal year 2005 consolidated financial statements, other matters involving internal control over performance measures may have been identified and reported. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

In connection with our fiscal year 2005 engagement, we performed tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the Department. Had we been able to perform all of the procedures necessary to express an opinion on the Department's fiscal year 2005 consolidated financial statements, other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether the Department's financial management systems substantially comply with (1) Federal financial management



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systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

Distribution

This report is intended for the information and use of the Department's management, the Department's Office of Inspector General, OMB, the Government Accountability Office, and the United States Congress, and is not intended to be used and should not be used by anyone other than these specified parties.

KPMG LLP

November 9, 2005

Financial Management and Reporting Controls

Our work identified significant deficiencies in the Department's financial management and reporting controls, collectively constituting a material weakness in internal control, that precluded the Department from preparing its fiscal year 2005 consolidated financial statements and supporting documentation in a complete and timely manner. Despite substantial effort by the Chief Financial Officer's staff, the Department was unable to correct these deficiencies in a timely manner and, as a consequence, we issued a disclaimer of opinion on the Department's fiscal year 2005 consolidated financial statements.

The Department has encountered a number of challenges resulting from the fiscal year 2005 implementation of its new accounting system, the Standard Accounting and Reporting System (STARS), consolidation and realignment of its financial and accounting services organization, and the adoption of a new chart of accounts. Specifically, in October 2004, the Department centralized certain operations previously performed by multiple field offices and accounting service centers and restructured its overall financial and accounting services organization. These changes, coupled with higher than normal attrition, had a negative impact on the financial accounting staffing levels and skills mix throughout the Department. Shortly thereafter, in April 2005, the Department implemented STARS and a new chart of accounts.

While the Department conducted extensive STARS pre-deployment testing, it encountered implementation issues related to converting data from its legacy accounting system, developing new accounting processes to effectively use the new system, and identifying related reporting requirements. The Department's new financial and accounting services organization was unable to fully address many of these implementation issues prior to September 30, 2005. Reports needed for management, control, and audit purposes were not available following STARS deployment, and a number of system reconciliations remained incomplete. Furthermore, new STARS-specific accounting processes had not been fully documented, and operational control procedures were not yet being performed routinely. Problems resulting from the lack of these critical controls significantly delayed preparation of the fiscal year 2005 consolidated financial statements and supporting data, and impacted the ability of management officials to monitor and control their budgets. The Department recognized these issues and classified financial control and reporting as a reportable problem in its *Federal Managers' Financial Integrity Act* assurance statement for fiscal year 2005, and as a non-compliance matter in its *Federal Financial Management Improvement Act* reporting.

Specifically, we noted the following issue areas:

Obligations, budget execution and funds control – We found unreconciled differences between the general ledger, subsidiary modules, and various other information systems used to manage obligation and cost data. Some field organizations entered and controlled obligations using separate information systems (feeder systems) that interface with the STARS purchase order module, while others recorded obligation data directly in the purchase order module. Some sites summarized transactions for posting in a manner that prevented the obligation data in STARS

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Exhibit I – Material Weakness, Continued

from being readily traced or reconciled to source documents. In addition, because the sites had not fully developed control procedures unique to their feeder systems and data entry methods, they could not ensure the accuracy of obligation data through timely reconciliation to the STARS general ledger totals. STARS data is needed for official funds control purposes. Without routine reconciliations, there is significant risk that the obligations reported in the Department's consolidated financial statements may be misstated and that field office and program managers may be using incomplete or inaccurate data for financial management decisions. Field offices also reported that they cannot identify and resolve some differences between STARS and contract file data. Because of the unexplained differences, several field offices expressed concerns regarding the accuracy of their uncoded and unpaid obligations balances, which adversely affected their ability to monitor and control their budgets. These and other program officials also expressed concerns regarding incorrect conversion of legacy system data, potential funds distribution errors, and inappropriate accrual of interest penalties. Finally, a number of program officials said that they needed additional training in using available reporting tools to monitor obligations and expenditures.

Payments – The Department has had difficulty reconciling its disbursement and collection activity with the U.S. Treasury's records since April 2005. STARS permits processing of payment transactions in excess of recorded costs. While this feature provides flexibility by permitting the posting of transactions prior to final cost allocation decisions, it also imposes the burden of ensuring that differences are promptly investigated and resolved. We also noted that when steps in the voided payment process were performed out of sequence, the resulting payments may not be recorded in the general ledger. These payment reconciliation issues have significantly complicated and delayed efforts to verify the accuracy of the Fund Balance with Treasury account. Because of these difficulties, the Department's submissions to Treasury and OMB as of June 30, 2005, were based on estimated disbursement data. In September, corrected SF-224s, *Monthly Statement of Transactions*, were submitted to Treasury for the period April through June 2005. The Department was unable to complete its September 2005 Fund Balance with Treasury reconciliation until November 4, which was after submission of the draft fiscal year 2005 consolidated financial statements for audit purposes.

Accruals – In fiscal year 2005, the Department implemented a revised process for field offices to submit accruals to Headquarters for costs incurred when invoices had not yet been received. We tested this process as of June 30, 2005, and determined that the recorded accrual data was unreliable. We identified accruals submitted by field offices that were either not entered or were duplicated in STARS, or were recorded inaccurately. We also noted accruals recorded prior to April 1, 2005, that had not been reversed, and a significant number of accruals that should have been recorded but were not identified by the field offices. These issues were not fully resolved by year-end. Additional issues arose during the year-end accrual process that required the CFO to request revised accruals from field offices in mid-October, which was too late to subject such accruals to audit testing. Finally, the year-end grant accrual validation process was not performed effectively.

Integrated contractor trial balances – A number of unreconciled differences existed between STARS and the separate financial systems maintained by the Department's integrated

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Exhibit I – Material Weakness, Continued

contractors. A task force formed to identify and resolve these differences found that they resulted from errors in data conversion and incomplete reconciliation and cross-walk instructions. While the Department believes that substantially all of the remaining differences resulted from misclassifications of data between contractors and field office reporting units - misclassifications that do not affect the accuracy of the consolidated financial statements - it had not completed most of the reconciliations for individual contractors, and the effect of the remaining corrections on the consolidated financial statements was not known. The Department plans to implement routine contractor trial balance reconciliations after these issues are resolved.

Reconciliation of data – Data conversion and operational problems created out-of-balance conditions between the STARS purchase order, accounts payable, accounts receivable, and fixed assets modules and the general ledger. The Department identified a number of reconciling differences and adjustments, but had not completed reconciliations of all modules to the general ledger as of September 30, 2005. Once these are completed, the Department intends to implement procedures and controls to ensure that the module reconciliations are performed routinely. In addition, the Department reported that several hundred general ledger posting errors identified by STARS edit routines were unresolved as of the date of our report. Although the Department implemented system changes to prevent many of these errors from recurring, it had not completed review and correction of unresolved errors. The Department requires field offices to resolve many of these errors, but staffing levels were not adequate to complete the work prior to the date the Department prepared its consolidated financial statements. In addition, new procedures and user reports are needed in some areas to record valid accounting transactions, such as transferring internal use software from construction in process to completed property accounts, entries that were rejected by STARS during processing. Prompt resolution of data posting errors is an essential component of financial data integrity, and its absence could make the safeguards against misappropriation or unauthorized use of funds less effective.

Identifying and reporting intragovernmental transactions – The Department developed new procedures to use with STARS to identify and code intragovernmental transactions by trading partner. OMB Circular A-136 requires Federal agencies to separately report intragovernmental balances in their financial statements and to report intragovernmental balances by trading partner as required supplementary information. Various coding and reporting issues were identified by the Department and through our testing, including issues with the program logic for extracting trading partner information and inaccuracies in the vendor and customer tables. Because of these issues, the Department did not prepare the required schedule of intragovernmental balances by trading partner for inclusion in its *Fiscal Year 2005 Performance and Accountability Report*.

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Exhibit I – Material Weakness, Continued

Recommendations:

We recommend that the CFO ensure that the Department:

1. Continues to improve accounting operations and controls related to STARS deployment, with an emphasis on:
 - Reconciling the general ledger to subsidiary ledgers and feeder systems;
 - Reconciling contractor trial balances to the general ledger;
 - Improving its controls for recording and accepting valid payment and obligations transactions;
 - Accounting for and recording accruals;
 - Classifying and reporting intragovernmental transactions;
 - Developing revised or additional reports for program officials to use to monitor and control budgets;
 - Performing data reconciliations routinely; and
 - Resolving error conditions;
2. Fully documents the business processes and controls required for the accurate and timely operation of the STARS system;
3. Implements routine controls; and
4. Provides additional training to its accounting staff and program officials.

Management's Response:

Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

Unclassified Network and Information Systems Security

The Department maintains a series of interconnected unclassified networks and information systems. Federal and Departmental directives require the establishment and maintenance of security over unclassified information systems, including financial management systems. Past audits identified significant weaknesses in selected systems and devices attached to the computer networks at some Department sites. The Department has implemented corrective actions to improve network security at the sites we, and the Department's Office of Independent Oversight and Performance Assurance (OA), reviewed in prior years. However, we and the OA continued to identify network security weaknesses at sites reviewed in fiscal year 2005, and the frequency and severity of those weaknesses remained consistent with our prior year findings. The Department recognizes these weaknesses and has classified cyber security as a significant issue in its *Federal Managers' Financial Integrity Act* assurance statement for fiscal year 2005. Significant improvements are still needed in the areas of password management, configuration management, and restriction of network services.

Our fiscal year 2005 audit also disclosed weaknesses in access at several sites, similar to our prior year findings. Specifically, we noted weaknesses in the review and approval of user access privileges, password security, and monitoring of networks for questionable activity. Further, the Department's Office of Inspector General also reported deficiencies in the Department's network and information system risk management, configuration management, and access controls in its evaluation report on *The Department's Unclassified Cyber Security Program*, dated September 2005. Matters discussed in that report included an examination of non-financial systems.

The Department has acknowledged the need to improve its information systems security and other information technology controls. In fiscal year 2005, the Department's Chief Information Officer (CIO) continued the implementation of initiatives from the prior years to identify the root causes of the control weaknesses and to develop new policies and procedures to strengthen controls and reduce network vulnerabilities. The Department also recently initiated its Cyber Security Improvement Initiative. This is a collaborative effort between the Office of the CIO (OCIO), OA, and the various program offices to conduct joint site visits to identify and resolve cyber security problems, provide site assistance, and follow-up on corrective actions. Once fully implemented, these initiatives and new policies and procedures should strengthen the Department's overall cyber security program.

The identified weaknesses in network vulnerabilities and access controls increase the risk that malicious destruction or alteration of data or unauthorized processing could occur. Because of our concerns, we performed supplemental procedures and identified compensating controls that mitigate the potential effect of these security weaknesses on the integrity of the Department's financial systems.

Recommendation:

While progress has been achieved, continued focus is needed to resolve the vulnerability and access weaknesses described above. Therefore, we recommend that the program officials, in conjunction with the CIO, fully implement policies and procedures to ensure that the Federal

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Exhibit II – Reportable Condition, Continued

information security standards are met and that networks and information systems are adequately protected against unauthorized access.

Detailed recommendations to address the issues discussed above have been separately reported to the program offices and the OCIO.

Management's Response:

Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendation.

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Exhibit III – Status of the Prior Year Audit Finding

Reportable Condition from Fiscal Year 2004
(with parenthetical disclosure
of year first reported)

Status at September 30, 2005

Unclassified Information Systems Security
(1999)

Still reported in Exhibit II as a reportable
condition.